UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF VIRGINIA
NEWPORT NEWS DIVISION

IN RE LUMBER LIQUIDATORS HOLDINGS, INC. SECURITIES LITIGATION	Master File No.: 4:13-cv-00157-AWA-DEM Hon. Arenda L. Wright Allen **CLASS ACTION**

LEAD PLAINTIFFS' OPPOSITION TO DEFENDANTS' MOTION TO DISMISS CONSOLIDATED AMENDED COMPLAINT

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Lead Plaintiffs David Lorenzo, Gregg Kiken, Keith Foster and Charles Hickman respectfully submit this Opposition to Defendants' Motion to Dismiss Plaintiffs' Consolidated Amended Complaint. ECF No. 83.

I. INTRODUCTION

This is a securities class action against Lumber Liquidators Holdings, Inc. ("Lumber Liquidators" or the "Company"), three of its former top officers – former President and CEO Robert M. Lynch, former Chief Merchandising Officer William Schlegel, former CFO Daniel Terrell – and founder and Chairman, Thomas Sullivan, for violations of §§ 10(b) and 20(a) of the Securities Exchange Act.[1] The Complaint is a well-plead document that fully satisfies Fourth Circuit precedent and the pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"). By contrast, Defendants' motion mischaracterizes the Complaint, disregards controlling precedent such as *Zak v. Chelsea Therapeutics Int'l, Ltd.*, 780 F.3d 597 (4th Cir. 2015), and ignores key allegations establishing that Defendants' statements were materially false and misleading, made with scienter, and caused losses to shareholders.

Lumber Liquidators sells hardwood and laminate flooring, competing primarily against Home Depot and Lowe's.[2] Between February 22, 2012 and February 27, 2015 (the "Class Period"), the Company reported record gross margins that were substantially higher than its major competitors. ¶2. Defendants' represented that the major driver of these high margins was legitimate "sourcing initiatives" in China that supposedly reduced the cost of goods and cut out middlemen. ¶¶47-53. In truth, however, the Company's low product costs and high margins were due to importing cheap flooring made from illegally-harvested wood and laminate that was contaminated with high levels of formaldehyde. ¶¶120-53.

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[1] The "Individual Defendants" refers to Lynch, Schlegel, Sullivan and Terrell. "Defendants" collectively refers to Lumber Liquidators and the Individual Defendants.

[2] ¶¶2, 6. References to "¶__" herein are to Lead Plaintiffs' Consolidated Amended Complaint For Violations Of The Federal Securities Laws, ECF No. 80 (the "Complaint").

When the truth emerged in a series of disclosures and events – including news of federal criminal charges for violations of the Lacey Act and the well-substantiated, televised broadcast by *60 Minutes* of extensive wrongdoing, the stock price plunged by 68% from Class Period highs. In the aftermath, the board suspended the sale of Chinese laminate products, Lynch, Schlegel, and Terrell abruptly resigned and the Company replaced its "compliance" officer.[3]

The Complaint sets forth four categories of misrepresentations and explains why they were false and misleading when made:

- ***Sourcing Initiatives and Basis for Margin Growth:*** Defendants represented that the Company achieved its extraordinary margin growth and earnings through legitimate "sourcing initiatives" such as "direct sourcing with international and domestic mills to control product cost and quality." *See, e.g.,* ¶¶215, 256, 265. These statements were false. As later revealed, the reported results were due to importing cheap Chinese-made product that used illegally-harvested wood and contained high levels of formaldehyde. ¶¶91-153.

- ***The Quality of Products and Quality Controls:*** Defendants represented, for example, that the Company "work[s] directly with our supplier mills to source and produce flooring that will meet our high quality standards" and "[w]e have personnel on the ground, in the mills …. [We] don't rely on a distributor to measure and control our quality … We do stringent testing of our products at multiple levels, beyond what's required." ¶¶167, 236. In truth, products suffered from formaldehyde contamination, and the Company's quality controls were patently deficient. ¶¶120-61.

- ***Compliance with Laws and Regulations and Compliance Controls:*** Defendants represented compliance with laws and controls for such compliance, representing for example that "we discontinue sourcing from suppliers not adhering to our standards." ¶¶273, 318. In truth, however, Defendants neither complied with laws nor adequately controlled for such compliance. ¶¶91-161.

- ***Inventory and Supply Capabilities:*** To address concerns after initial revelations that the Company sourced non-compliant products from China, Lynch and Terrell assured

[3] *See infra* notes 6-10.

investors that margin growth would continue because the Company's strong and diverse supply network was sufficient to meet demand. ¶288. However, the market learned just two months later that the network of suppliers was deficient and unable to provide compliant product. ¶359.

In their motion, Defendants disregard most of their misrepresentations during the Class Period and attempt instead to raise factual disputes about their compliance with laws and the reported margins.[4] The Complaint, however, sets forth each false and misleading statement and explains why each was false and misleading. ¶¶162-319. Moreover, Defendants misrepresented current and historic facts; even their statements couched as "opinions" are actionable because the speaker omitted material facts. *See Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

While Defendants now claim to have been in the dark about their products and operations in China, the allegations of scienter can hardly be stronger. The Complaint fits "the classic fact pattern[] giving rise to a strong inference of scienter" because Defendants "knew facts or had access to information suggesting that their public statements were materially inaccurate." *S.E.C. v. Pirate Investor LLC*, 580 F.3d 233, 243 (4th Cir. 2009). Not only did Defendants have intimate knowledge of the source and quality of products from Chinese mills and made repeated representations on the subject, they understood that the only explanation for the unusually low prices was corrupt product. ¶¶335-50. Given the ease with which outside third parties – such as investigators for *60 Minutes* and the Environmental Investigation Agency ("EIA") – discovered the illicit practices, there is a strong indication that insiders at Lumber Liquidators likewise knew of such practices. The inference of scienter is particularly strong because the insiders directly profited through insider selling and lucrative bonuses. Defendants' spin of the facts – that Lumber Liquidators' dramatic margin growth was due to legitimate "sourcing initiatives" and that the high levels of formaldehyde resulted from a "scientific disagreement" – is implausible and contradicts the Complaint's allegations.

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[4] *See* Memorandum in Support of Defendants' Motion to Dismiss Plaintiffs' Consolidated Amended Complaint, ECF No. 83, ("Def. Br. __") at 27-29.

Ultimately, the truth about Lumber Liquidators' reported margins and practices was disclosed in a series of announcements and events between June 20, 2013 and March 1, 2015. ¶¶28, 352-71. For example, on March 1, 2015, *60 Minutes* televised damaging evidence against the Company, including undercover video and their interview with Sullivan that caused the Company's stock price to decline by over 25%. ¶¶368-71. The Complaint, therefore, amply alleges loss causation in accordance with *Dura Pharms. Inc. v. Broudo*, 544 U.S. 336, 346 (2005). Advancing an unprecedented defense to loss causation, Defendants blame "negative publicity" for investor losses. Def. Br. at 2. This is absurd. "Negative publicity" virtually always accompanies disclosure of corporate fraud.

II. SUMMARY OF COMPLAINT

A. The Flooring Industry, China And Gross Margins

Lumber Liquidators, one of the largest specialty retailers of hardwood flooring in the United States, operated in an intensely-competitive industry throughout the Class Period. ¶¶6, 8. The Company's two main competitors, Lowe's and Home Depot, controlled more than twice the market share than Lumber Liquidators. ¶8. Through 2011, the gross margins for all three companies were comparable, fluctuating between 34% - 35%. ¶¶9, 46.

Facing constant pressure to reduce prices while increasing margins, the Company's founder and Chairman, Sullivan, hired CEO Lynch and Chief Merchandising Officer Schlegel specifically to improve margins through its China operations. ¶¶47-48. Both Lynch and Schlegel had previously gained "extensive experience in direct sourcing in China." ¶¶53, 54, 105. Their bonuses were directly tied to improved margin and operating income growth. ¶331.

In 2011, Lumber Liquidators acquired Sequoia Flooring ("Sequoia"), its trading partner in China, providing Defendants with unprecedented insight into the Company's Chinese-made products. ¶¶49, 50, 57. Lynch and Schlegel personally conducted "line reviews" which required Chinese suppliers to bid against each other, awarding business to the supplier with the lowest price.

¶¶47, 48, 51, 55. Defendants publicly boasted that they personally inspected the mills' sourcing practices and that the Company tested the wood from each mill to ensure quality and legal compliance. ¶¶54-59. "We have personnel on the ground, in the mills …. ***[We] don't rely on a distributor to measure and control our quality … We do stringent testing of our products at multiple levels, beyond what's required.***" [5]

B. Defendants' Undisclosed Practices To Increase Margins

The Lacey Act bans the import and trade of illegally-sourced wood products (including wood products imported in violation of foreign laws). ¶¶69-73. The Company purchased timber from the Russian Far East ("Russia"), exposing it to liability and enforcement under the Lacey Act. ¶91. To deliberately conceal the illegal source of the wood during the Class Period, the Company mislabeled the shipments "because any wood that is declared as Russian in origin receives intense scrutiny due to the high likelihood that it was harvested illegally." ¶¶107, 115, 118-19. Ultimately, executives at Lumber Liquidators' primary China supplier, Suifenhe Xingjia Economic and Trade Company ("Xingjia"), admitted to illegally harvesting wood and to providing tours of these illegal operations to the Company's executives, including Schlegel. ¶¶97-111.

Lumber Liquidators also achieved record margin growth by importing cheap products from China containing high levels of formaldehyde. ¶¶120-21. Formaldehyde is a known carcinogen and a key component in the production of laminate and engineered flooring. ¶82. The California Air Resources Board ("CARB") set limits on how much formaldehyde may be released from wood products (¶86) and requires compliance from importers like Lumber Liquidators. ¶85.

Multiple independent laboratory tests confirmed that the formaldehyde level of the Company's Chinese imports was higher than that of Lumber Liquidators' American-made product and higher than laminates from Lowe's and Home Depot. ¶¶126-41. *60 Minutes*, for example, tested 31 boxes of Chinese-made products purchased from Lumber Liquidators' stores outside of

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[5] ¶¶58, 236. Throughout, emphasis is added and citations have been omitted unless otherwise indicated.

California and all but one of the 31 samples tested contained levels of formaldehyde that exceeded CARB limits. ¶¶137-39. *60 Minutes* conducted a second test that measured the concentration of formaldehyde emissions from flooring products into the air of a typical home which resulted in a finding of "polluted indoor conditions" for Lumber Liquidators' Chinese-made products. ¶140. The environmental advocacy group "Global Community Monitor" conducted independent lab tests finding that the Company's Chinese-made flooring emits formaldehyde at levels far above the level requiring cancer warnings under California law. ¶¶132-36.

A known risk when importing from China is contamination from cheap products. ¶123. As explained in *Sourcing From China: How To Import From China*, "[a]n extremely low quote should set off alarm bells" because "inferior materials would be used." ¶124. Employees of three different Chinese mills admitted to undercover investigators that they used materials contaminated with high levels of formaldehyde to manufacture Lumber Liquidators' products, saving the Company 10-15% on price. ¶¶144-47. At all three mills these employees admitted to falsely labeling the Company's laminate flooring as CARB 2, meaning it meets California formaldehyde emissions standards, which the Company is required to follow. ¶¶143-47, 369. Defendants knowingly purchased products at 10% below standard prices – an enormous advantage over competitors. ¶¶121, 125, 144-46, 148. The low price reflected high levels of formaldehyde, confirmed repeatedly by lab testing and witness accounts. ¶¶109, 120-53.

C. Defendants' Misrepresentations And Insider Selling

Defendants reported dramatically improved margins during the Class Period skyrocketing to an astounding 41.8% by the third quarter 2013. ¶11. By comparison, the gross margins for Lowe's and Home Depot remained between 34.3% and 34.8% for the years 2012 and 2013. *Id.* Defendants claimed that the unprecedented margins and financial results were a result of legitimate "sourcing initiatives" to reduce the cost of goods, cut out middlemen, and strengthen relationships with their suppliers. *See, e.g.,* ¶173. Defendants omitted that Lumber Liquidators imported illegally-harvested wood in violation of the Lacey Act (¶¶91-119) and cheap products that were contaminated with formaldehyde. ¶¶120-53, 245.

Defendants disclosed in the Company's public filings that "certain of our products are subject to laws and regulations relating to the importation, acquisition or sale of illegally-harvested plants and plant products and the emissions of hazardous materials." ¶¶171, 221, 271, 316. Yet, despite their awareness of numerous unlawful practices, Defendants claimed, "[w]e work closely with our suppliers to ***ensure compliance with the applicable laws and regulations*** in these areas" relating to the environment and protection of natural resources (¶¶171, 221, 271, 316) when in fact, Defendants imported products in violation of the Lacey Act. Similarly, Defendants represented "[w]e select suppliers ***based on a variety of factors, including their ability to supply products that meet industry grading standards*** and our demanding product specifications, which support the ***high-quality*** nature of our brands" (¶213) when in truth, Lumber Liquidators imported products which failed CARB formaldehyde standards. ¶¶120-53.

As a result of the false statements and omissions, the Company's stock price soared during the Class Period, from $19.17 to a high of $115.44 in less than two years. ¶14. The insiders capitalized on the inflated price by unloading over $85 million of their own shares, with the vast majority of sales by Lynch, Schlegel, and Terrell occurring in the Summer of 2013, selling almost all vested holdings near $100 per share. ¶¶14, 320-30.

D. The Truth Emerges And The Aftermath

Between June 20, 2013 and March 1, 2015, the relevant truth about Lumber Liquidators' practices was revealed and previously-concealed risks materialized. These disclosures included, among others: the 2Q 2014 Earnings Announcement (stock price declined $15.17 per share, 21.5%, ¶¶359-64), the February 25, 2015 Earnings Call (stock price declined $18.15 per share, 26.39%, ¶¶365-67), and the *60 Minutes Report* (stock price declined $13.03 per share, 25.13%, ¶¶368-71). In total, the Company's stock price dropped by 68% from its high during the Class Period, and investors lost over $1.52 billion in market capitalization. ¶28.

The U.S. Consumer Product Safety Commission recently confirmed that the agency was investigating Lumber Liquidators' products for excessive amounts of formaldehyde. ¶161. The DOJ confirmed that it would be seeking criminal charges under the Lacey Act (¶365); the

Company suspended sales of its Chinese laminate products[6] and accepted the "resignations" of Defendants Terrell,[7] Lynch,[8] and Schlegel,[9] as well as Chief Compliance Officer, Ray Cotton.[10]

III. ARGUMENT

The Court, when considering a motion to dismiss, "must accept the factual allegations in the complaint as true." *In re Genworth Fin. Inc. Sec. Litig.*, 2015 U.S. Dist. LEXIS 57600, at *16 (E.D. Va. Mar. 1, 2015). "At this juncture, it is not the Court's duty to evaluate whether Plaintiffs' assertions are true, but rather to determine whether their Complaint is sufficient." *Arnlund v. Smith*, 210 F. Supp. 2d 755, 759 (E.D. Va. 2002). "[C]ourts are limited to considering the sufficiency of allegations set forth in the complaint and the 'documents attached or incorporated into the complaint.'" *Zak*, 780 F.3d at 605 (reversing dismissal when district court considered extraneous material and drew inferences against plaintiffs). To even be considered, the documents must be "integral to and explicitly relied on in the complaint." *Id.* at 607-08. While the Court may take judicial notice under Fed. R. Evid. 201 of "a fact that is not subject to reasonable dispute," "***the court must construe such facts in the light most favorable to the plaintiffs***." *Id*. at 608.

Ignoring *Zak* and the legal standards, Defendants submit 34 exhibits attempting to support their motion without explaining how they are "integral" or appropriate for judicial notice.[11] Nearly half of the exhibits are not referenced in the Complaint.[12] They include, for example, Defendants'

[6] *See* Press Release, *Lumber Liquidators Provides Update On Laminate Flooring Sourced From China* (May 7, 2015) attached as Exhibit 20 to the Declaration Of Lyle Roberts In Support Of Defendants' Motion To Dismiss Plaintiffs' Consolidated Amended Complaint, ECF No. 84, ("Def. Ex. __").

[7] *See* Lumber Liquidators, Current Report (Form 8-K) (Apr. 29, 2015).

[8] *See* Lumber Liquidators, Current Report (Form 8-K) (May 21, 2015).

[9] *See* Lumber Liquidators, Current Report (Form 8-K) (June 15, 2015).

[10] *See* Michelle Celarier, Embattled Lumber Liquidators Loses Another Top Exec, NY Post, June 2, 2015 *available at* http://nypost.com/2015/06/02/embattled-lumber-liquidators-loses-another-top-exec/.

[11] *See* Def. Exs. 1-34.

[12] *See* Def. Exs. 2, 5-7, 10, 12, 17-20, 22-25, 33.

attempt to introduce a Company "presentation" to analysts that was created ***during the pendency of this litigation***. *See* Def. Ex. 2. Defendants may not rely on their own statements to dispute the Complaint.[13] Defendants also wrongly urge the Court to consider extraneous material concerning purported margin growth (Def. Exs. 5, 6), CARB compliance, harvesting from Russia, and a chart characterizing their insider sales that Defendants created for litigation purposes. Def. Exs. 7, 17-20, 22-25. Accordingly, these exhibits and the accompanying arguments should be stricken.

A. The Complaint Amply Alleges False And Misleading Statements

The Complaint pleads "*sufficient* facts to support a reasonable belief in the allegation that a defendant's statement was misleading." *Carlucci v. Han*, 907 F. Supp. 2d 709, 727 (E.D. Va. 2012). It "is not necessary for Plaintiff to prove absolute, incontrovertible falsity." *Id*. Rather, Plaintiffs must only "allege[] facts and 'circumstances that, drawing reasonable inferences in their favor, would render their claims [of falsity] plausible'" and "'are not required to 'prove' the falsity of the alleged misrepresentations' at the pleading stage." *Nieman v. Duke Energy Corp.*, 2013 U.S. Dist. LEXIS 110693, at *24-25 (W.D.N.C. July 26, 2013). As a general rule, "whether a public statement is misleading . . . is a mixed question to be decided by the trier of fact." *In re STEC Inc. Sec. Litig.*, 2011 WL 2669217, at *9 (C.D. Cal. June 17, 2011). To satisfy Fed. R. Civ. P. 9(b) and the PSLRA, the complaint identifies "the time, place, speaker and contents of the allegedly false statement." *Genworth,* 2015 U.S. Dist. LEXIS 57600, at *18.

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[13] *See Epstein v. World Acceptance Corp.*, 2015 U.S. Dist. LEXIS 64494, at *4-5 n. 2 (D.S.C. May 18, 2015) ("In accordance with the Fourth Circuit's recent directives in *Zak* and in construing the facts in the light most favorable to Plaintiff, this Court declines to take judicial notice of any SEC documents that do not relate to the contents of the Amended Complaint and will not consider such materials as evidence contradicting the Amended Complaint."); *see Williams v. Chase Manhattan Mortg. Corp.,* 2005 U.S. Dist. LEXIS 45605, at *13 (W.D.N.C. Oct. 11, 2005) (noting the "crucial distinction between taking judicial notice of the fact that an entity has filed a document in the case, or in a related case, on a given date, *i.e.,* the existence thereof, and the taking of judicial notice of the truth or falsity of the contents of any such document for the purpose of making a finding of fact"); *Ademiluyi v. Pennymac Mortg. Inv. Trust Holdings I, LLC*, 929 F. Supp. 2d 502, 512 (D. Md. 2013) (refusing to take notice of the substantive contents of Form 10-K because it would be inappropriate "without an opportunity for further factual development by way of discovery").

Here, the Complaint meets these standards, alleging in detail Defendants' misrepresentations and omissions concerning: (i) the Company's sourcing initiative and the basis for the Company's low product costs and high margins;[14] (ii) the quality of Lumber Liquidators' products and controls for quality;[15] (iii) the Company's compliance with environmental laws and controls for compliance;[16] and (iv) the inventory and supply capabilities for compliant products.[17] In their motion, Defendants do not challenge the allegations of falsity for misrepresentations about sourcing initiatives, product quality, controls, or inventory and supply constraints.

1. Misrepresentations About The Sourcing Initiatives And The Basis For Margin Growth

Defendants represented that the Company's extraordinary margins, revenue and earnings were achieved by legitimate "sourcing initiatives" when, in reality, they resulted from cheap Chinese-made products that used illegally-harvested wood (¶¶47-53; 69-80; 91-119) and high levels of formaldehyde.[18] Lynch described the Company's sourcing initiatives as "conducting line reviews and expanding our product assortments" and to "further leverage our China office" following its acquisition the previous year. ¶175. The Company described these initiatives as "[c]urrent and potential mill partners' participation in competitive line reviews" and "[d]irect sourcing with international and domestic mills to control product cost and quality." ¶¶215, 265. Defendants failed to disclose they were also importing unlawful and dangerous products.[19]

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[14] ¶¶164, 173, 176, 181, 184, 188, 191, 192, 200, 204, 210, 215, 217, 223, 225, 228, 230, 234, 245, 258, 265, 279, 285, 288, 293, 312.

[15] ¶¶167, 169, 173, 191, 196, 204, 213, 215, 217, 223, 233, 236, 238, 240, 247, 252, 256, 263, 265, 273, 275, 277, 310, 312, 318.

[16] ¶¶171, 208, 219, 221, 240, 247, 263, 269, 271, 273, 310, 316, 318.

[17] ¶¶286, 288-90, 294, 300, 307, 309, 311, 313, 315.

[18] ¶¶81-90, 120-61. Because these undisclosed sourcing initiatives were unlawful, the margin, income and net sales growth were also ***unsustainable***. ¶¶13, 174, 183, 186, 194, 199, 206, 214, 218, 224, 226, 231, 246, 257, 266, 268, 278-80, 290. *See Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2002) ("[U]pon choosing to speak, one must speak truthfully about material issues."). "By attributing [the Company]'s success solely to legitimate practices, defendants implicitly (and falsely) warranted that there were no illegal practices contributing to that success." *In re Syncor Int'l Corp. Sec. Litig.*, 239 F. App'x 318, 320 (9th Cir. 2007).

Moreover, the Company repeatedly attributed increases in gross margin to the "sourcing initiatives." ¶¶164, 181, 188, 200, 210, 258, 314. Lynch publicly credited the sourcing initiatives with causing the Company's dramatic gross margin expansion on analyst conference calls. *See* ¶¶184, 191, 198, 204, 223, 275, 285. During the 2013 Goldman Sachs conference attended by Lynch, Terrell and Schlegel, Defendant Lynch represented that the dramatic increase in gross margins since 2011 was due to the Company's sourcing initiatives (direct purchasing and line reviews). ¶245. Similarly, Terrell stated, "[w]ithin our sourcing initiatives, gross margin continued to benefit from the impact of line reviews and the establishment of direct relationships with our vendor mills, particularly in China, following our September 2011 acquisition." ¶192. Securities analysts viewed the sourcing initiatives as important. *See* ¶¶177, 185, 193, 202, 205.

In their Motion, Defendants contend that the Complaint does not quantify the exact impact Defendants' improper sourcing practices had on Lumber Liquidators' financial performance. Def. Br. at 28-29. Not so. The Complaint plainly alleges Defendants' improper sourcing practices caused the Company's margins to increase from 34-35% in 2011 to an "astounding 41.8% by the third quarter 2013." ¶11, *see also* ¶¶9, 249. Nothing more is needed at this stage. *See In re Jiffy Lube Sec. Litig.*, 772 F. Supp. 258, 266 (D. Md. 1991) ("pleading the exact amount of certain overstatements of income or the amount by which reserves for doubtful accounts were understated, is unnecessary at this stage"). Moreover, Plaintiffs simply must specify each misleading statement, why it was false, and all facts on which the belief was formed.[20] The Complaint does so.

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[19] *See In re Gentiva Sec. Litig.*, 932 F. Supp. 2d 352, 368-69 (E.D.N.Y. 2013) ("The statements by Gentiva put the source of its Medicare revenue at issue, and such, the alleged failure to disclose the true sources of this revenue [Medicare fraud] could give rise to liability under § 10(b)."); *In re Van Der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 400-401 (S.D.N.Y. 2005) ("if [a defendant] puts the topic of the cause of its financial success at issue, then it is 'obligated to disclose information concerning the source of its success, since reasonable investors would find that such information would significantly alter the mix of available information.'").

2. Defendants Misrepresented Product Quality

Defendants falsely represented the quality of the Company's products and compliance with quality controls. The 2011 Form 10-K falsely states that the Company "***work[s] directly with our supplier mills to source and produce flooring that will meet our high quality standards***." ¶167. Defendants also falsely represented that the Company's products comply with industry standards and government regulations. ¶¶169, 171. Similarly, the 2012 Form 10-K states,"[w]e select suppliers ***based on a variety of factors, including their ability to supply products that meet industry grading standards*** and… the ***high-quality*** nature of our brands." ¶213. Moreover, Lynch repeatedly stated that the Company works directly with mills providing superior control over quality. ¶¶196, 223, 275. Having made representations about product quality, Defendants were obligated to tell the truth without material omissions.[21]

Defendants' statements concerning product quality and quality control were false and misleading. Defendants omitted that their laminates were contaminated with high levels of formaldehyde, failed to comply with industry standards, and failed to meet CARB regulations concerning acceptable formaldehyde emissions. ¶¶81-90, 120-61, 168, 170, 174, 197, 214, 224,

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[20] *See* 15 U.S.C. § 78u-4(b)(1); *Ross v. Career Educ. Corp.,* 2012 WL 5363431, at *5-6 (N.D. Ill. Oct. 30, 2012) (finding allegations regarding manipulations of a school's job placement rates sufficiently alleged a material misrepresentation, even though the actual placement rate was not specified); *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 933-35 (9th Cir. 2003) (falsity and materiality of airline utilization rates sufficiently pled without specifying or calculating actual rate).

[21] *See Ottmann v. Hanger Orthopedic Grp. Inc.*, 353 F.3d 338, 352 (4th Cir. 2003) (accepting plaintiffs' argument that defendants "had a duty to disclose" certain material information and concluding that because defendants had "made positive comments" the complaint "sufficiently plead that [defendants] made a misleading omission"); *see In re Computer Scis. Corp. Sec. Litig.*, 890 F. Supp. 2d 650, 668-69 (E.D. Va. 2012) (same); *see also Longman v. Food Lion, Inc.*, 197 F.3d 675, 683 (4th Cir. 1999) (in "particular contexts when it is both factual and material, [opinion or puffery] may be actionable.").

241, 276. Such negative information is clearly material to a reasonable investor. *See Computer Scis.*, 890 F. Supp. 2d at 690 (failure to disclose negative information gave misleading impression that company was capable of performing on key contract was clearly material to investors).

3. Misstatements And Omissions About Compliance And Controls

Defendants misrepresented the Company's compliance with environmental laws and controls for compliance. For example, in its Annual Reports, the Company stated: "We invest significant time and resources to safeguard quality and comply with regulatory requirements. We discontinue sourcing from suppliers not adhering to our standards." ¶¶273, 318. Similarly, the Company represented in 2013 that it "has policies and procedures in place for the sourcing, harvesting and manufacturing of its products designed to comply with federal and other regulations related to the importation of wood flooring products." ¶247. Lumber Liquidators' website represented that the Company's "flooring comes from managed forests" and that "Lumber Liquidators offers flooring brands that practice responsible harvesting." ¶179. The website also touted that "[t]ree cutting is monitored very carefully within a selective cutting and replanting strategy" and that "[f]looring mills must submit harvesting plans to the local government for approval." *Id*. The Company also represented that it worked closely with its suppliers to ensure compliance. ¶¶171, 219, 221, 269, 271, 316.

Moreover, the Company's Forms 10-K filed during the Class Period state, "[w]e are able to set demanding specifications for product quality and our own quality control and assurance teams are on-site at the mills, coordinating inspection and assurance procedures. . . . We seek long-term, core relationships with mills committed to our demanding product specifications, sustainable supply and regulatory compliance." ¶263, 310. Similarly, Lynch represented "***We augment the on-site controls with additional testing in both our own labs and in independent, certified facilities"*** and the "combination of our on-site controls and our additional testing is designed to ensure that our process exceed the highest regulatory requirements ***and meet our more stringent internal quality standards***." ¶240.

Defendants' statements were false and misleading. In truth, Defendants did not ensure Chinese suppliers' compliance with applicable laws and regulations and instead imported products: (1) that contained and emitted high levels of formaldehyde and failed to comply with CARB regulations (¶¶81-90, 120-61); and (2) made from illegally-harvested lumber. ¶¶69-80, 91-119. *See In re Massey Energy Co. Sec. Litig.*, 883 F. Supp. 2d 597, 614-18 (S.D. W.Va. 2012) (disclosure of Massey's compliance with safety laws ruled false and misleading where the defendants closely aligned their statements of regulatory compliance with the Company's success); *see also Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 742 (9th Cir. 2008) (finding that the company's assurance that it was in compliance with securities laws sufficiently plead falsity); *In re Allaire Corp. Sec. Litig.*, 224 F. Supp. 2d 319, 337 (D. Mass. 2002). The fact that Defendants were intentionally violating the Lacey Act, by itself, would be material to investors.[22]

Defendants also failed to disclose that Lumber Liquidators had inadequate internal controls to ensure compliance with environmental laws and regulations. ¶¶174, 194, 197, 224, 237, 241, 248, 253, 264, 311. The Company's former Chief Compliance and Sustainability officer, Cotton, admitted that Lumber Liquidators ***"did not begin building a compliance team in China until December of 2014."*** ¶344. *See Meyer v. Jinkosolar Holdings Co., Ltd.*, 761 F.3d 245, 251 (2d Cir. July 31, 2014) (reversing district court's dismissal and holding that defendants' statements of compliance controls created a duty to disclose "ongoing and serious pollution violations"). Lumber Liquidators' supposed tests for contamination were "laughable – so few samples for such a huge volume of products." ¶¶156, 345. In the aftermath of the *60 Minutes* disclosure, the Company's compliance officer "resigned," and the board suspended sales of Chinese products.[23]

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[22]*See, e.g., In re Am. Apparel, Inc. S'holder Litig.*, 855 F. Supp. 2d 1043, 1067 (C.D. Cal. 2012) (where the company stated that it "makes diligent efforts to comply with all… immigration laws" the complaint was adequate where it alleged that one-third of the company's employees at a single facility were illegal immigrants, "it is a plausible inference that there were significant compliance problems at the time the statements were made.").

[23] *See supra* notes 6 and 10.

Defendants contend that they had no obligation to disclose the truth of their sourcing practices in China.[24] Defendants are wrong. "As the Supreme Court emphasized in *Matrixx Initiatives*, 'companies can control what they have to disclose under [§ 10(b) and Rule 10b-5(b)] by controlling what they say to the market.'" *Zak*, 780 F.3d at 609 (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1322 (2011)). Thus, the "defendants' failure to [disclose practices] must be viewed under § 10(b) and Rule 10(b)-5(b) in the context of the statements that they affirmatively elected to make." *Id.*

Relying on extraneous material, Defendants contend that "less than 2% of its hardwood purchases … consisted of oak purchased from northern China."[25] In truth, two of the Company's largest Chinese suppliers admit to supplying the Company with illegally-harvested wood. ¶¶91-112. And, the Company's largest supplier admits that (i) 90% of its wood was unlawfully harvested; (ii) Lumber Liquidators was its largest purchaser; and (iii) the illegally harvest wood was used in the Company's purchases. *Id.* In a single year, the Company received more than three million square feet of flooring containing illegally-sourced wood from Xingjia alone. ¶¶97, 112. Finally, the Complaint is not limited to just oak flooring or suppliers located in ambiguously-defined area of "northern China." Xingjia was the Company's largest China supplier, not merely of oak flooring and it unlawfully harvested in China, not just Russia. ¶¶61, 105. Xingjia had at least fourteen sawmills and multiple factories, several located outside the northern city of Suifenhe. ¶96. At best, Defendants' disputes are questions of fact, inappropriate at this stage.

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[24] Def. Br. at 29. Defendants cite *Iron Workers Local 16 Pension Fund v. Hilb Rogal & Hobbs Co.*, 432 F. Supp. 2d 571, 586-87 (E.D. Va. 2006) and *Weill v. Dominion Res., Inc.*, 875 F. Supp. 331, 337 (E.D. Va. 1994) for the unremarkable proposition that a company does not always have a duty to disclose illegal acts unless the omission rendered an identifiable statement misleading. Here, Defendants' numerous sourcing initiatives descriptions required complete disclosure.

[25] Def. Br. at 28-29. The Court may not consider Defendants' material for the truth of the matters asserted therein, and certainly not for the purpose of contravening Lead Plaintiffs' well-pled allegations. *See Williams*, 2005 U.S. Dist. LEXIS 45605, at *13 (noting the "crucial distinction between taking judicial notice of the fact that an entity has filed a document in the case, or in a related case, on a given date, *i.e.* the existence thereof, and the taking of judicial notice of the truth or falsity of the contents of any such document for the purpose of making a finding of fact.").

Ignoring *Omnicare*, 135 S. Ct. 1318, Defendants contend that their false statements were "opinions," and are not actionable unless "disbelieved by its maker, and related to matters of fact which can be verified by objective evidence.'" Def. Br. at 27. Not only do Defendants apply an incorrect legal standard, they are wrong.[26] The only statement that Defendants identify as "opinion" is in paragraph 271 and ellipsed in Defendants' Motion. "We believe that we currently conduct, ***and in the past have conducted***, our activities and operations in substantial compliance with applicable ***laws and regulations relating to the environment and protection of natural resources.*** " Def. Br. at 27. This statement is actionable because Defendants omitted facts showing that the statement had no reasonable basis and misrepresented the "supporting fact[s]" underlying their repeated assertions that the Company complied with applicable laws and regulations. *See Genworth*, 2015 U.S. Dist. LEXIS 57600, at *43. Moreover, having raised a strong inference of scienter (*see*, Section B, *infra*), the Complaint amply alleges that the statements about the Company's legal compliance were not genuinely held. *See Omnicare*, 135 S. Ct. at 1331.

4. Defendants Misrepresented The Company's Inventory And Supply Capabilities

Following initial revelations of non-compliant Chinese-made products, Lynch assured investors that the supplier network remained strong and was more than capable of providing sufficient inventory to meet demand: "the [sourcing] initiatives we have implemented over the last three years ***have our stores and supporting operations prepared to fully capture available customer demand***… [a]s a result, our outlook for the full year remains intact." ¶288 (emphasis added). Terrell assured investors of continued margin growth: "[w]e expected there to be

[26] Under *Omnicare*, a defendant is liable for false statements of opinion in any of three circumstances: (i) the "supporting fact[s]" provided for the stated opinion are false or misleading; (ii) the speaker omits facts showing that it lacked a reasonable basis for the stated opinion; or (iii) the stated opinion is not genuinely held. While *Omnicare* addressed claims under the Securities Act of 1933, the Supreme Court's reasoning extends to claims arising under § 10(b) of the Exchange Act. *See Genworth*, 2015 U.S. Dist. LEXIS 57600, at *42-43. Under *Omnicare*, "the omission of a fact can make a statement of opinion ..., even if literally accurate, misleading to an ordinary investor." *Id*. at 1327.

continuing juice from each one of the product margin drivers." ¶289. Similarly, Defendants stated that increases in gross margins would continue. ¶286. As admitted just two months later, these statements were false and misleading because the network of suppliers was not diversified and could not provide sufficient inventory to meet customer demand ***with products that complied with the Lacey Act and formaldehyde standards.*** ¶¶290, 294, 300, 307, 309, 311, 313, 315.

B. The Complaint Raises A Strong Inference Of Scienter

A complaint raises a strong inference of scienter by "setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior, and the adequacy of the scienter allegations is to be measured by the facts collectively alleged in the complaint." *Genworth*, 2015 U.S. Dist. LEXIS 57600, at *55; *Massey*, 883 F. Supp. 2d at 622 ("[t]he proper focus of a court's inquiry with respect to scienter is whether 'all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.'"). The inference of scienter "need not be irrefutable, *i.e.*, of the smoking-gun genre, or even the most plausible of competing inferences." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007) (internal quotation marks omitted). "After comparing the 'malicious and innocent inferences cognizable from the facts pled,' a complaint will not be dismissed so long as 'the malicious inference is at least as compelling as any opposing innocent inference.'" *Zak*, 780 F.3d at 606 (quoting *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 991 (9th Cir. 2009)). "When making the assessment whether scienter has been adequately pleaded, it is prudent to keep in mind that the PSLRA does not require a plaintiff to prove his case in his complaint" and "a plaintiff generally must frame the facts [of the case] without the benefit of discovery." *Arnlund v. Deloitte & Touche LLP*, 199 F. Supp. 2d 461, 475 (E.D. Va. 2002).

1. Defendants Knew Facts And Had Access To Information Suggesting Their Public Statements Were False And Misleading

Here, the Complaint sets forth detailed factual allegations specifically explaining how each of the Individual Defendants knew, or was reckless in not knowing, that Lumber Liquidators' dramatic margin gains were achieved by improper and undisclosed means.

First, Defendants had intimate non-public knowledge of the source and quality of products they purchased from Chinese mills. ¶¶54-59, 337, 340, 341. The risks of importing substandard products from China are well documented and were known to Defendants. ¶123. Schlegel, the Company's "Chief Merchant," frequently traveled to China, "dug in with the vendors" and "spearheaded" the "professional line review process" and other initiatives in China. ¶¶55, 245. Witnesses confirm Defendants' personal involvement.[27] Schlegel's knowledge of the Company's illegal sourcing from protected forests is confirmed by statements from Xingjia's executives, who when asked point blank if Lumber Liquidators was aware of the illegal harvesting said, "Yes, of course they know that." ¶¶104, 105, 111, 337. As early as 2011, Defendants Schlegel and Lynch were "actually both there in China working" on the Company's sourcing initiatives that imported illegally-harvested and contaminated products. ¶54. Schlegel reported directly to Lynch, who also frequently traveled to China, working hand-in-hand with Schlegel to personally inspect the mills and conduct line reviews. ¶¶62-63. It is implausible that Defendants Schlegel and Lynch were oblivious to the illegal sourcing.[28] The fact that a defendant publishes statements when in possession of facts suggesting the statements are false is "classic evidence of scienter."[29]

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[27] ¶108. *See also* ¶105. For example, several witnesses established that Lynch and Schlegel regularly traveled to China to visit suppliers and negotiate supply agreements. ¶¶62, 63, 65. CW1 stated that Schlegel traveled to China frequently to oversee operations, find new Chinese suppliers, and reported back his findings to Lynch. ¶62. CW4, who worked directly with Schlegel and accompanied him on trips to China, regularly communicated information from the personnel in Shanghai to Schlegel. ¶66. According to CW2, the Company's buyers in China all reported to Schlegel, who was responsible for quality assurance. ¶64.

[28] *See Computer Scis.*, 890 F. Supp. 2d 650 at 669 (CEO "acted with scienter when making the misleading statements" about performance on a particular contract, which was one of the company's largest, one that the CEO "said he 'watch[ed] most closely' and had his 'utmost attention.'"); *In re Landry's Seafood Rest., Inc.*, 2001 WL 34115784 (S.D. Tex. Feb. 20, 2001) (allegations that defendant closely monitored the subject matter where the fraud occurred was sufficient to plead scienter); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003) ("the fact that [the CFO] was aware that the financial statements were false reduces the likelihood that [the CEO] was ignorant of that fact.").

[29] *Pirate Investor*, 580 F.3d at 243 (citing *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002)); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001) ("[o]ne of the classic fact patterns giving rise to a strong inference of scienter is that defendants

Moreover, "[w]here a statement is made repeatedly regarding an issue of specific personal interest to the officers, the allegations will more readily give rise to the requisite strong inference of scienter." *Dobina v. Weatherford Int'l Ltd.*, 909 F. Supp. 2d 228, 246 (S.D.N.Y. 2012). Here, the Defendants repeatedly represented the benefits of the Company's sourcing directly from Chinese mills. For example, on a conference call on July 24, 2013, Lynch stated, "***we have personnel on the ground, in the mills. . . [We] don't rely on a distributor to measure and control our quality. . . We do stringent testing of our products at multiple levels, beyond what's required***." ¶¶58, 236, 238. Defendants Lynch and Terrell repeated these same representations throughout the Class Period. ¶¶175-76, 184, 191, 196, 223, 243. Such repetition supports scienter. *Massey*, 883 F. Supp. 2d at 620-22 (defendants' frequent public statements regarding Massey's commitment to safety and public use of incident rate data support the "stronger" inference of scienter where defendants ignored known safety violations). Numerous cases are in accord.[30]

Defendants wrongly contend that Schlegel's knowledge cannot be imputed to the Company. Def. Br. at 12 n.10 and 21. "A complaint that alleges facts giving rise to a strong inference that ***at least one corporate agent acted*** with the required state of mind satisfies the PSLRA even if the complaint does not name the corporate agent as an individual defendant or otherwise identify the agent." *Matrix Capital Mgmt. Fund, LP v. BearingPoint, Inc.*, 576 F.3d 172, 189 (4th Cir. 2009); *see also Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) (explains that the complaint need not name the corporate agent who acted with scienter

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published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate."); *Epstein*, 2015 U.S. Dist. LEXIS 64494, at *21 ("strong inference of the existence of recklessness by claiming that Defendants had information about the true nature of its business conditions and performance but withheld marking certain disclosures in order to control the timing and flow of the information").

[30] *See, e.g., Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 271 (3d Cir. 2009) (repeated misrepresentations about core issues such as these support an inference that the Company's executives were "paying close attention" to them); *Dobina*, 909 F. Supp. 2d at 246 ("[w]here a statement is made repeatedly regarding an issue of specific personal interest to the officers, the allegations will more readily give rise to the requisite strong inference of scienter.").

to impute to the corporation). Here, the scienter of Lynch, Terrell, Schlegel, and Sullivan (at the very least) is imputed to Lumber Liquidators.[31]

Second, the Company assumed direct control of product sourcing in China when it acquired Sequoia. ¶¶55-57. Lumber Liquidators no longer relied on distributors to monitor sourcing practices at the mills in China and instead sourced "directly" which provided "***insight and visibility throughout the sourcing process***." ¶57. The Company's website represented that it "worked directly with a select group of vendors and mills" with whom the Company has "cultivated long-standing relationships." ¶208. The Company would "often pay announced and unannounced visits" to its suppliers of illegally-harvested or contaminated products. *Id*. Thus, by their own accounts, Defendants "knew facts or had access to information suggesting [their] public statements were not accurate" regarding the deficiencies in product quality. *Carlucci*, 907 F. Supp. 2d at 729; *see also In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983, 1022 (S.D. Cal. 2005) ("[T]hat the defendants published statements when they knew facts suggesting the statements were inaccurate … is classic evidence of scienter.").

Third, Defendants understood, when the Company received laminates at 10% below the standard price that the product was of dubious quality. ¶¶123-25, 144-48, 342-43. Defendants are all sophisticated players in the industry with decades of combined experience. ¶¶35-39, 41-46, 54-59, 105, 125. The only explanation for such low prices in China is corrupt material. "An egregious refusal to see the obvious or investigate the doubtful" is a hallmark of recklessness. *Novak v. Kasaks*, 216 F.3d 300, 308-309 (2d Cir. 2000). In 2011, Lumber Liquidators' gross margins skyrocketed due to use of illegally-harvested wood and laminates contaminated with high levels of formaldehyde. ¶¶53, 249.

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[31] Defendants' cases are easily distinguished and actually support a finding of Lumber Liquidators' scienter. *See Computer Scis.,* 890 F. Supp. 2d at 667 ("since the complaint sufficiently pleads that 'at least one corporate agent' 'acted with the required state of mind,'… the allegation is sufficiently pled as to the Company, a well."). Contrary to Defendants' contention, *Teachers' Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 184 (4th Cir. 2007) and *Computer Scis. do not require* the corporate agent to make *a false statement* in order for her knowledge to be imputed to the corporation.

Defendants contend they were unaware the reduction in costs would materially impact gross margins. Def. Br. at 22 (citing *Davis v. SPSS, Inc*., 385 F. Supp. 2d 697, 716 (N.D. Ill. 2005)). In *Davis*, the plaintiff alleged that individual sales people would improperly book deferred revenue to win monthly bonuses but "d[id] not provide any indication of the scope or impact of these sales practices." *Id*. Here, by contrast, Lynch and Schlegel were top officers and directly involved in importing from China. Lynch was brought aboard specifically to alter Lumber Liquidators "sourcing initiatives" in order to increase reported gross margin. ¶¶47, 48, 54. Lynch "brought a new Chief Merchant, Bill Schlegel, with him" to help accomplish these goals. ¶56. Terrell told analysts that Lynch and Schlegel were responsible for this success. *Id.* Moreover, in every annual report (¶¶217, 267, 314) earnings announcement (¶¶164, 181, 188, 200, 210, 258), and analyst call (¶¶184, 191, 198, 204, 223, 275, 279, 285), the Defendants credited the sourcing initiatives in China as the key driver of the Company's success.[32]

Fourth, Chinese-made flooring is a key product for the Company's core operations. Unlike Home Depot and Lowe's, Lumber Liquidators' entire business is flooring, and its Chinese imports drove its margins. ¶¶346, 347. High-ranking officers – such as Terrell, Lynch and Schlegel – know facts about the core operations of the Company. *See Genworth*, 2015 U.S. Dist. LEXIS 57600, at *58 (*quoting South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008)) ("'[a]llegations that rely on the core-operations inference are among the allegations that may be considered in the complete PSLRA analysis.'"); *see also Yates v. Mun. Mortg. & Equity, LLC*, 744 F.3d 874, 890 (4th Cir. 2014) (holding that allegations relating to a core business "are relevant to the court's holistic analysis of scienter"); *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 199 (S.D.N.Y. 2010) (finding scienter where misstatements concerned a "core

[32] *In re Winn-Dixie Stores, Inc. Sec. Litig.*, 531 F. Supp. 2d 1334, 1350 (M.D. Fla. 2007) is inapposite because there, the court found that vague allegations that executives would attend meetings regarding the company's business was not specific enough to support an inference of scienter. Here, the factual allegations concerning the Company's officers' personal and direct involvement in the sourcing of flooring products from China are detailed and specific.

operations"); *Reese v. Malone*, 747 F.3d 557, 569, 575-77 (9th Cir. 2014) (It is "reasonable to conclude that high-ranking corporate officers have knowledge of the critical core operation of their companies."). The cases relied on by Defendants are inapposite.[33]

Fifth, the ease with which outside third-parties discovered the sale of illegally-harvested wood and contaminated product further demonstrates scienter because it demonstrates the practices were obvious. ¶¶109, 126-53, 336. Courts find a strong inference of scienter even when internally, the fraud is discovered by new internal personnel. For example, "the fact that [a] new CEO . . . discovered the [issues] within months of taking the position is a strong indication that these [misstatements] were obvious enough that a new officer found them quickly." *In re New Century*, 588 F. Supp. 2d 1206, 1231 (C.D. Cal. 2008); *see also In re Reliance Sec. Litig.*, 91 F. Supp. 2d 706, 725 (D. Del. 2000) (allegations that new CFO "discovered that the Company's income was overstated within weeks of becoming its CFO" support scienter). Independently, Zhou (¶¶126-31), Global Community Monitor (¶¶132-36) and *60 Minutes* (¶¶137-43) easily discovered the practices behind the Company's reported margins.

With respect to Lacey Act violations, one of Lumber Liquidators' suppliers, Xingjia, "was well known to Russian logging enforcement agencies as one of the worst illegal loggers in the region." ¶102. A simple Russian-language Google search for Xingjia's suppliers, such as "Beryozoviy illegal logging Khabarovsk" or "Investstroy illegal logging" returns numerous news articles describing recent illegal logging violations." ¶101. Xingjia's connection to illegal sourcing would be obvious to anyone doing business with Xingjia as the "EIA report states that numerous sources throughout the RFE reported to undercover EIA investigators that at least 80% of all trees harvested in the area are done so illegally." ¶100. Through a simple inquiry to Xingjia, a Russian logging enforcement agency, or even a Google search, Defendants would have learned of Xingjia's practices. ¶¶72, 78, 100-02. Moreover, the Company took steps to conceal the Lacey Act violations by mislabeling its products with the wrong mills and countries of origin.[34]

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[33] For example, in *Tyler v. Liz Claiborne, Inc.*, 814 F. Supp. 2d 323, 343-44 (S.D.N.Y. 2011), the court rejected an allegation that business constituting 16% of sales was a "core" business but also held that "[t]he 'core operations doctrine' bolsters the strength of the inference of scienter when plaintiff has already adequately alleged facts indicating that defendants might have known their statements were false." Here, the products at issue comprise significantly more than 16% of Lumber Liquidators' business. Solid and laminate wood flooring made up between 43-48% of the Company's net sales, solid and engineered hardwood and laminate flooring together accounted for hundreds of millions of dollars of sales for Lumber Liquidators, and between 40-50% of the Company's products were sourced from China. ¶¶346-47.

Defendants' cases are off-point. In *Ottman*, 353 F.3d at 351, the Fourth Circuit recognized that red flags, like those here, raise a strong inference of scienter, but found in that case that vague assertions of access to company documents were insufficient. Similarly, *Brophy v. Jiangbo Pharm., Inc.*, 781 F.3d 1296, 1304 (11th Cir. 2015) found allegations insufficient to establish inference of scienter because "complaint provides no explanation as to how these red flags should have alerted [the defendant] to the fraud"). Here, the Complaint specifically alleges Defendants were aware of the hazards of importing from China, absurdly low prices, core products, lack of internal quality controls, and the numerous customer complaints concerning formaldehyde odors.

Moreover, Defendants Lynch, Terrell and Schlegel all resigned in rapid succession following the revelation of the fraud.[35] "Although the decision to terminate the defendants does not negate the possibility of mere negligence in mismanaging the [] issue, it more likely suggests a higher level of wrongdoing approaching recklessness or even conscious malfeasance."[36] Multiple resignations may indicate that a company is engaging in "house-cleaning" and may support scienter, especially when combined with other allegations in a holistic analysis. *See In re AM. Serv. Grp, Inc.* 2009 U.S. Dist. LEXIS 28237, at *159 (M.D. Tenn. Aug. 28, 2006) (defendant corporation's firing of two executives and the resignation of members of the company's audit committee, along with "sweeping internal reforms" indicates fraud.).

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[34] ¶¶107, 115, 118-19; *see SEC v. Fox*, 855 F.2d 247, 253 (5th Cir. 1988) (attempts to conceal the fraud support an inference of scienter); *Brown v. China Integrated Energy, Inc.*, 875 F. Supp. 2d 1096, 1124 (C.D. Cal. 2012) ("evidence of concealment is strongly indicative of scienter"); *In re Connetics Corp. Sec. Litig.*, 2008 U.S. Dist. LEXIS 62515, at *46 (N.D. Cal. 2008) (finding a strong inference of scienter when the defendant "took efforts to conceal his [misconduct]").

[35] *See supra* notes 7-9.

[36] *In re Overseas Shipping Grp., Inc. Sec. Litig.*, 12 F. Supp. 3d 622, 633 (S.D.N.Y. 2014) (finding scienter adequately pleaded and collecting cases).

2. The Individual Defendants Directly Benefitted From The Fraud

A "strong inference" of scienter arises "where a plaintiff sufficiently alleges that a defendant benefited in a concrete and personal way from the fraud." *Carlucci*, 907 F. Supp. 2d at 729 (citing *In re IBM Corp. Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998)). Here, the Individual Defendants' insider selling and unusual bonuses support scienter. *See Tellabs*, 551 U.S. at 325 (allegations of "personal financial gain may weigh heavily in favor of a scienter inference.").

The performance-based compensation for Lynch and Schlegel *was tied directly to improvements in the Company's gross margin and operating income*. ¶¶331-32. The Complaint shows specifically how much they profited during the Class Period. ¶334. Consistent with *Tellabs*, courts routinely find that the defendants' motive and opportunity to inflate the price of the company's stock, including performance based bonuses, support an inference of scienter.[37]

Moreover, despite the Company announcing record results on July 24, 2013, and telling investors that "[w]e expect to . . . [expand] gross margin through continued execution of our sourcing initiatives" (¶234), Defendants Lynch and Schlegel sold *almost all their stock* between May 14, 2013 and July 31, 2014, *just two months before the government's Lacey Act raid* on

[37] *See In re MicroStrategy, Inc. Sec. Litig*. 115 F. Supp. 2d 620, 631 (E.D. Va. 2000); *Winslow v. Bancorpsouth, Inc.*, 2011 WL 7090820, at *23 (M.D. Tenn. Apr. 26, 2011) ("[w]hile bonuses do not necessarily equate with motivation to commit fraud, 'they can be catalysts to fraud and so serve as external markers to the required state of mind.'"); *see also In re Paincare Holdings Sec. Litig.*, 541 F. Supp. 2d. 1283, 1293 (M.D. Fla. 2008) (allegations that "bonuses were tied to the Company's earnings" supported scienter); *Zuckerman v. Smart Choice Auto. Grp., Inc.*, 2000 WL 33996254, at *5 (M.D. Fla. Aug. 29, 2000) (allegations that "compensation package had incentive provisions tied to the [company's] financial performance" supported scienter). *Iron Workers Local 16 Pension Fund*, 432 F. Supp. 2d at 591 relied upon by Defendants is easily distinguished because the plaintiff there made only general allegations "that the Individual Defendants were motivated to defraud investors to obtain increased compensation." Here, Lead Plaintiffs specifically allege that the Individual Defendants' compensation was directly tied to the Company's gross margin and operating income. ¶¶331-34.

September 26, 2013. Defendants' sales support scienter and when the transactions of the insiders are examined together, an even more suspicious pattern of sales emerges. ¶¶326-28.

- ***Lynch*** sold 154,500 shares – over 99.94% of his vested options and over 93% of his holdings for an instant profit of over $10 million. ¶322.

- ***Schlegel*** exercised and sold 100% of his 15,591 stock options for an immediate profit of $1,076,997.44. ¶325. Prior to these sales, neither Lynch nor Schlegel had sold any Company stock, except for a minor sale by Lynch to pay a tax liability. ¶¶321, 325.

- ***Terrell*** sold 138,710 shares, exercising over 97% of his vested options between November 7, 2012 and July 31, 2013, for a profit of $7,566,264.54. ¶323. In the previous six years, Terrell had not sold a single share. *Id*.

- ***Sullivan*** sold an astounding 1,590,803 shares, over 72% of his holdings between September 28, 2011 and August 22, 2013, for a total of $60,216,632.10. ¶324.

Defendants speculate that because every single sale did not occur at the Class Period high, these suspiciously timed sales were mere coincidence. Def. Br. at 22-26. However, Defendants could not know exactly when the Class Period high would be because they did not control the timing of the corrective disclosures. Defendants' argument is also completely inapplicable to Schlegel and Lynch. Over 97% of their sales (165,551 shares) occurred above $85.00/share. Defendants Schlegel and Lynch also made 100% of their sales during the last two "trading windows" (Def. Br. at 24-26) before the government raid on September 26, 2013. Schlegel's and Lynch's last sales were at $93.3521 per share and $97.90 per share. The stock price on the last day of the final trading was $99.40 (August 30, 2013). They sold everything at the last possible moment. This is not a coincidence.

Defendants have "cherry picked" the facts to suit each particular insider defendant.[38] For example, while Lynch sold all of his shares at prices above $80, Defendants ignore the fact that these sales *represent almost 100% of his vested options.* ¶¶321-22. Instead, Defendants' focus on Lynch's Class Period purchases as evidence of his confidence in the Company's future profits. Def. Br. at 24. Lynch's modest purchase of 6,000 shares, however, *amounts to less than 3% of the number of shares sold.* While those 6,000 shares cost him $303,768, *his massive Class Period sales reaped over $21 million*. Lynch's purchases were made *after the 30% drop following the July 9, 2014 disclosure* when shares traded around $50, *prices not seen in nearly two years*. ¶¶321-22, 359-64; Def. Br. at 24. Similarly, Defendants gloss over Terrell's insider sales with the summary conclusion that his trading cannot be suspicious because 84% of those sales were at prices less than half of the Class Period high. Def. Br. at 24. Those sales *still represented 94% of Terrell's sellable shares and options at a price nearly three times higher than at the start of the Class Period*. ¶323. Defendants had no way of predicting just how much artificial inflation their fraud would cause in the price of Lumber Liquidators' stock. When the price reached $97.40, Terrell liquidated most of the rest of his shares, *leaving less than 3% of his sellable shares unsold*. *Id*. Finally, Defendants also fail to address the fact that Sullivan sold 75% of his remaining shares and options between the Sequoia acquisition in 2011 and the DOJ raid on September 26, 2013, *or that he never purchased a single share* during this time. Def. Br. at 23. "[I]f the timing and amount of a defendant's trading were unusual or suspicious," it will support a strong inference of scienter.[39] Defendants' cases are easily distinguished.[40]

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[38] Def. Br. at 23-25. Defendants also improperly submit material from outside the Complaint, attempting to spin the facts surrounding their insider trading. *See* Def. Exs. 28 and 29. Not only is this improper under *Zak*, but Defendants also ignore their vested options. ¶322 ("Lynch engaged in a wholesale selloff of stock, exercising 130,000, or 99.98% of his vested options); ¶323 ("Terrell

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exercised over 94% of his vested options, selling 116,960 share of stock"); ¶325 ("On July 29, 2013, he [Schlegel] exercised every last one of his vested options and sold all 15,591 shares … ").

[39] *See Teachers' Ret.*, 477 F.3d at 184; *see also MicroStrategy*, 115 F. Supp. 2d at 647 (same); *Yates*, 744 F.3d at 890 (this Circuit considers "the amount of profit made, the amount of stock traded, the portion of stockholdings sold, or the number of insiders involved.").

[40] *In re PEC Solutions Sec. Litig.*, 2004 WL 1854202, at *13 (E.D. Va. May 25, 2004), *aff'd*, 418 F.3d 379 (4th Cir. 2005) is not on point because the plaintiff there failed to plead with particularity and *In re Travelzoo Inc. Sec. Litig.*, 2013 WL 1287342, at *10 n.9 (S.D.N.Y. Mar. 29, 2013) is not on point as there the defendant's sale during class period "was [not] inconsistent with her prior trading practices" and she sold half of her shares before the class period. Defendants' reliance on *Ronconi v. Larkin*, 253 F.3d 423, 436 (9th Cir. 2001) is similarly misplaced because there, unlike here, defendants' sales were completed before the alleged misconduct even began and the plaintiffs

3. Defendants' Alternative Explanations Are Not Plausible

In determining scienter, "the question for the Court is whether 'the allegations in the complaint, viewed in their totality and in light of all of the evidence in the record, allows [the Court] to draw a strong inference, at least as compelling as any opposing inference,' that Defendants knowingly or at least recklessly defrauded investors by way of the alleged misstatements." *Epstein*, 2015 U.S. Dist. LEXIS 64494, at *20 (quoting *Pub. Emps' Ret. Ass'n of Colo. v. Deloitte & Touche LLP*, 551 F.3d 305, 313 (4th Cir. 2009)).

Defendants' alternative explanations for their misrepresentations are hardly compelling. They contend that Lumber Liquidators' dramatic margin growth during the Class Period was due exclusively to legitimate "sourcing initiatives" (*e.g.*, the Sequoia acquisition and having its suppliers compete with one another in "line-reviews"), and that CARB violations are merely the result of a "scientific disagreement." Def. Br. at 13-14. This competing inference contradicts the Complaint's allegations and the only plausible inference of the facts, which investors identified immediately. ¶¶354, 356, 358, 364, 367, 371. As one analyst reported: "Last night's expose on LL by *60 Minutes* produced one major development, in our view… the [Chinese] mills explained they are capable of manufacturing CARB compliant flooring but it would cost 10-15% more, ***suggesting LL did not want to pay the higher price in order to earn higher profits…***" ¶370.

Claiming to be in the dark, Defendants contend that there are disagreements concerning proper testing methodologies (Def. Br. at 14-15) and improperly direct the Court to self-serving exhibits created after this litigation commenced that are not integral to the Complaint.[41] This case

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did not have compelling allegations of underlying fraudulent conduct. Finally, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997) is inapposite because there, unlike here, the two principal defendants did not sell any stock during the class period.

[41] For example, Defendants improperly attempt to turn the present motion to dismiss into a summary judgment motion by citing extraneous exhibits (*see, e.g.*, Def. Br. at 14 and Def. Ex. 21 "Script for Business Update Conference Call Attached to the Company's March 12, 2015 Form 8-K at 13); *see Zak*, 780 F.3d at 605 (reversing dismissal when district court considered extraneous material and drew inferences against plaintiffs).

is not about a "scientific disagreement" over formaldehyde testing – it is about an undisclosed practice to increase reported margins by purchasing cheap product made from illegally-harvested and contaminated material. Defendants' cases add no support to their argument. For example, *In re Vertex Pharm. Inc., Sec. Litig.*, 357 F. Supp. 2d 343, 355 (D. Mass. 2005) involved a scientific disagreement ***within*** the company as to the potential viability of a drug in development.[42] Defendants' reliance on *Corban v. Sarepta Therapeutics, Inc.*, 2015 WL 1505693, at *11 (D. Mass. Mar. 31, 2015) is similarly misplaced as there is no question about the substance of the debate here as the government, several private organizations, and investors each independently tested Lumber Liquidators products and found that they emitted dangerous amounts of formaldehyde. ¶¶126-53.

Contrary to Defendants' contention, there is no legitimate dispute concerning whether the tests conducted for *60 Minutes* were done correctly and that the products tested failed to comply with CARB standards. "*60 Minutes* used both 'core' testing (*i.e.*, testing performed on the medium density fiberboard 'core' of deconstructed laminate flooring) and 'surface' testing (*i.e.*, testing performed on the 'surface' veneer or the top of the laminated surface of the product) methods properly." ¶150. The first test was designed to determine whether the products were CARB compliant (¶¶137-39) while the second test measured the concentration of formaldehyde emissions from laminates into the air of a typical home as proscribed by the California Department of Public Health. ¶¶140-41. Lumber Liquidators failed both tests according to multiple sources, such as the President of the Hardwood Plywood & Veneer Association and analysts at Wedbush.[43]

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[42] *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 966-67 (D. Md. 1995) is inapposite for similar reasons and *In re Biogen Sec. Litig.*, 179 F.R.D. 25, 38 (D. Mass. 1997) was a decision on a motion for summary judgement where discovery was permitted on the matter.

[43] ¶¶151-52. Defendants' attempt to sow confusion concerning the Consumer Product Safety Commission's ("CPSC") decision to use "surface" testing for its particular investigation does not explain away the fact that Lumber Liquidators' products have repeatedly failed "core" or deconstructive testing which "is a key component of CARB-compliant testing." ¶150. It also does not change the fact that Lumber Liquidators' products failed surface testing conducted by *60 Minutes* (¶141) and was required to sell products compliant with CARB standards throughout the Class Period, but failed to do so. ¶86. On March 12, 2015, the Company's CEO, Defendant

Defendants' alternative explanation is further undermined by the consequences of increased attention. As soon as regulatory scrutiny was placed on Lumber Liquidators' practices, the Company's gross margins plummeted, resulting in the first year-over-year contraction of gross margin since the second quarter of 2011. ¶359.

C. The Complaint Adequately Pleads Loss Causation

To plead loss causation, a plaintiff must "'provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.'" *Nieman*, 2013 U.S. Dist. LEXIS 110693, at *27 (quoting *Dura*, 544 U.S. at 347). "Whether the plaintiff has proven causation is usually reserved for the trier of fact." *Carlucci*, 907 F. Supp. 2d at 724. "A plaintiff can successfully alleged the causal connection via one of two approaches." *Massey*, 883 F. Supp. 2d at 625. *First*, "demonstrate a causal relationship by identifying 'corrective disclosures' that 'revealed to the market the undisclosed truth' and causes the decline in share price." *Id*. "These corrective disclosures must reveal to the market, *in some sense*, the fraudulent nature of the practice about which plaintiff complains." *Id*. *Second*, "by pleading that a previously concealed risk materialized, causing the plaintiff's loss." *Id*.

A plaintiff may plead "loss causation on the theory that the truth was gradually revealed to the market place over time, meaning that 'neither a single complete disclosure or a fact-for-fact disclosure of the relevant truth to the market is a necessary prerequisite to establishing loss causation (although either may be sufficient).'" *Epstein*, 2015 U.S. Dist. LEXIS 64494, at *22-23 (quoting *Katyle v. Penn Nat'l. Gaming, Inc.*, 637 F.3d 462, 471-73 (4th Cir. 2011)). Ignoring this holistic analysis, Defendants challenge each disclosure in isolation, asserting that because no single disclosure by itself revealed the entire fraud, the Court should find *as a matter of law* that Defendants' misrepresentations did not cause any stock price decline. The Complaint describes a specific set of "corrective events" which came out over time and were counteracted by Defendants'

Lynch, admitted to investors that CARB's preliminary tests had revealed high levels of formaldehyde even before the *60 Minutes* broadcast. ¶153.

false reassurances. These events removed the artificial inflation of Lumber Liquidators' shares, causing the stock price to decline. ¶¶352-71.

The June 20, 2013 SeekingAlpha Article: On June 20, 2013, *SeekingAlpha* revealed that two laboratories tested one of Lumber Liquidator's Chinese-made products, concluding that it emitted formaldehyde over 3.5 times the legal limit. ¶¶127, 353. The article expressly tied the contaminated product to the sourcing initiatives and rise in gross margin. ¶126 ("skeptics have wondered how an $8 million acquisition [Sequoia] could have such a dramatic effect on gross margin."). These facts partially revealed the falsity of Defendants' prior statements concerning legitimate sourcing initiatives, resulting in a decline of $5.53, or 6.73%, in the Company's stock price while Defendants continued to make misrepresentations. ¶354. *See Nieman*, 2013 U.S. Dist. LEXIS 110693, at *27 (finding loss causation adequately pled because "Plaintiffs have identified the disclosures on July 3 and July 5-6, 2012 that revealed Defendants' actions… and the $4.53 per share drop in Duke's stock price that followed those disclosures"). Contrary to Defendants' assertions, the number of boxes tested by *SeekingAlpha* does not negate loss causation.[44]

Government's Investigation, Sept. 27, 2013 and Feb. 25, 2015*:** The September 27, 2013 announcement of the DOJ raid at the Company's headquarters (¶¶17-19, 355-56), and the February 25, 2015 announcement that the Company expected criminal charges being filed under the Lacey Act (¶¶22, 365-67) revealed to the market facts concerning importation of products made from illegally-harvested wood, causing the stock price to decline by $5.83 and $18.15, respectively. ¶¶356, 366-67. This is sufficient for pleading loss causation. *See Epstein*, 2015 U.S. Dist. LEXIS 64494, at *23 (holding that loss causation was sufficiently alleged because the complaint included "detailed assertions as to the manner in which certain 'truths' about World's [lending] practices, ***including an announcement about a federal investigation, were revealed to the market over time which caused World's stock prices to decline") (emphasis added). In addition to disclosing the relevant truth, the raid is the materialization of the concealed risk.[45]

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[44] Def. Br. at 31. Defendants' reliance on *Metzler Inv. GMGH v. Corinthian Coll.*, 540 F.3d 1049 (9th Cir. 2008) is misplaced as the court there did not impose any type of "company-wide" threshold for loss causation. Rather, the Ninth Circuit found the price declined as a result of poor earnings, not the announcement regarding problems at a single campus. *Id*. at 1065.

Defendants overstate the holdings in *Loos v. Immersion Corp.*, 762 F.3d 880, 890 (9th Cir. 2014) and *Meyer v. Greene*, 710 F.3d 1189, 1201 (11th Cir. 2013). In each case, the plaintiffs relied exclusively on a single announcement of an investigation *standing alone* as a "corrective disclosure" without anything more. *See, e.g., Loos,* 710 F.3d at 890 ("the announcement of an investigation, ***without more***, is insufficient to establish loss causation.") (emphasis added). Here, the government's investigation announcement is buttressed by: (1) the government's advanced receipt of the EIA Report describing illegal sourcing in Russia (¶¶17-19); (2) the government's raid of the headquarters to serve a search warrant (¶355); (3) Tilson's presentation connecting the illegal harvesting practices to the increased margins (¶¶20, 357); (4) the decline in margins as the Company attempted to comply with the law (¶¶21, 361-63); and (5) announcement that the DOJ would file *criminal charges* for Lacey Act violations stemming from the investigation. ¶¶22, 365-66. These allegations are precisely the "**something more**" that was missing in *Loos* and *Meyer*. *See Public Empl. Ret. Sys. of Miss. v. Amedisys, Inc.*, 769 F.3d 313, 324 (5th Cir. 2014) ("district court erred in imposing an overly rigid rule that government investigations can never constitute a corrective disclosure in the absence of a discovery of actual fraud.").

The Tilson Presentation, November 22, 2013: The November 22, 2013 Tilson Report concluded that the Company's unprecedented margin growth was caused almost exclusively from reduced product cost as a result of illegal sourcing in China. ¶¶357-58; *see* Def. Ex. 14. Tilson connected the dots of previously disparate sources and facts. ¶357 ("Mr. Tilson demonstrated that the Company was only able to maintain its unbelievably high margins, and thus inflate its revenues, as a result of importing illegal timber."). The immediate $13.55 decline in the Company's stock price (¶358) demonstrates the import of this analysis and precludes dismissal at this stage.[46]

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[45] *See also Caplin v. Trans1, Inc.*, 973 F. Supp. 2d 596, 603-06 (E.D.N.C. 2013) and No. 7:12-CV-23-F, Slip Op. at 12 (E.D.N.C. May 5, 2014) (alleged the risk of the insurance scheme "materialized" for loss causation pleading upon receipt of a government subpoena because the existence of an analyst report connected the subpoena to the company's scheme); *Massey*, 883 F. Supp. 2d at 625 (revelations that Massey faced criminal investigations as a result of "regulatory and safety problems that had been fraudulently concealed from investors provided a further manifestation of the hidden risks arising from defendants' misconduct").

Defendants contend that the disclosure did not "reveal the truth" because Tilson's analyses utilized facts available elsewhere. Def. Br. at 32. This Circuit holds, however, that the truth can be revealed from any source as long as it "reveal[s] to the market in some sense the fraudulent nature of the practices about which a plaintiff complains."[47]

Second Quarter 2014 Earnings Announcement: The announcement of poor financial results is sufficient to plead loss causation when those results are connected to the subject matter of the alleged fraud. *See Massey*, 883 F. Supp. 2d at 625 (Masseys' quarterly earnings both considered adequate for loss causation pleading because they revealed earnings based on the correction of safety and regulatory violations). Here, the Company's July 9, 2014 earnings announcement admitted that, contrary to Defendants' recent statements (¶¶288-89), its poor financial performance was the result of "inventory unavailability" for "key products, including laminates, vinyl plank and engineered hardwoods" (the very products implicated by the formaldehyde and Lacey Act violations) as the Company's suppliers attempted to address compliance problems. ¶¶359-63. Analysts immediately recognized the poor results were "a direct impact from the allegedly illegally harvested wood investigation" concerning China. ¶360. Moreover, the disclosure admitted that inventory constraints were due to "certain [Chinese] mills and their supply chains experienced delays in meeting the revised requirements." ¶¶361-62; *Lefkoe v. Clothiers*, 2007 U.S. Dist. LEXIS 98777, at *26-27 (D. Md. 2007) ("revelation of the true financial status of the Company… disclosing a decline in gross profit margins" and resulting in stock price decline were "sufficient to satisfy the loss causation pleading requirements for a § 10(b) claim"). Defendants' reliance on *In re Omnicom Group Securities Litigation*, 541 F. Supp. 2d 546, 552 (S.D.N.Y. 2008) is misplaced.[48]

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[46] *See In re Winstar Comm'ns*, 2006 WL 473885, at *16 (S.D.N.Y. Feb. 27, 2006) (loss causation upheld where a report based on publicly available financial information provided conclusion which the court determined could not have been reached by a reasonable investor and plaintiffs' allegations that the stock price fell following the issuance of those reports supported finding).

[47] *Katyle*, 637 F.3d at 473-75. Defendants again rely on the *pre-Haliburton* decision in *Meyer*, where the Eleventh Circuit stated that a new analysis of previously disclosed facts could never be a corrective disclosure because the underlying facts – as well as any conclusions that could be drawn from them – were immediately incorporated into the price upon disclosure, stating "[e]ither the market is efficient or it is not." *Meyer, 710 F.3d* at 1199. This extreme view was subsequently rejected in *Halliburton Co., v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2409 (2014) where the Court explained that market efficiency is not a yes/no "binary" question but rather a spectrum analysis that "depend[s] on how widely the information is disseminated and how easily it is understood." *Id*.

60 Minutes Announcement (February 25, 2015) And Broadcast (March 1, 2015): When Lynch disclosed that *60 Minutes* would feature the Company in an "unfavorable light with regard to our sourcing and product quality, specifically related to laminates," (¶365), analysts easily connected it to the fraud relating to contaminated products. For example, "Piper Jaffray downgraded Lumber Liquidators shares 'following the recent announcement that *60 Minutes* will likely be airing a negative piece on LL this weekend regarding formaldehyde emissions in certain flooring products.'" ¶366. In response, the stock price declined $18.15 per share (26.39%). ¶367.

On March 1, 2015, *60 Minutes* aired its television report which revealed new facts, including the results of a more extensive investigation, which included (1) testing results of Chinese-made flooring purchased outside of California (¶¶137-41, 368); (2) new footage of Chinese-mill employees admitting that they used formaldehyde-contaminated materials to make *and mislabel* products because it saved Lumber Liquidators 10-15 percent (¶¶144-48, 369); and (3) Defendant Sullivan admitting this new evidence called into question the Company's oversight.

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[48] There, the court found loss causation was not alleged because neither the company nor the market attributed the company's business decision or management resignation to the subject of the alleged fraud. *Id*. at 352-53. Defendants reliance on *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 471 (S.D.N.Y. 2005) makes no sense because whether the Company now wishes to mischaracterize the inventory constraints as the result of "remedial measures" and "prudent corporate governance" (which should improve the stock price) does not change the fact that analyst made the connection to the fraud and the stock price dropped significantly. ¶¶359-64.

¶370. Analysts connected these illegal practices as the source of the Company's high margins. *Id*. The next day, Lumber Liquidators' stock price plummeted $13.03 per share (25.13%). ¶371.

Accordingly, the disclosures amply allege causation. *See Massey*, 883 F. Supp. 2d at 625-26 (allegations sufficient to support loss causation concerning: (1) the "safety and compliance record" which "became known to the public, following the UBBM explosion"; and (2) the "explosion, itself, which revealed a materialization of the risk that Massey 'fraudulently concealed and downplayed risks to the safety of miners and the extent to which Massey was in compliance with regulatory requirements, thereby concealing conditions that were likely to-and ultimately did-lead to mining accidents, reduced production, increased operating and regulatory costs, and lower profits'"). Contrary to Defendants' assertion, a 2014 consumer lawsuit does not defeat causation. *See* Def. Br. at 34. The *60 Minutes* Broadcast revealed, for the first time, the results of two separate and different tests of products purchased outside California (¶¶138-41), undercover investigation and interviews in China (¶¶144-47), and admissions by Sullivan. ¶157. Moreover, Defendants' contention that the lab tests of the Company's products (which are mass produced) demonstrate nothing more than those particular products violated the law is belied by the market's reaction, Defendant Sullivan's own comments, the Company's subsequent suspension of all sales of Chinese laminate products, and resignations of Defendants Lynch, Terrell, and Schlegel.

D. Defendants Are Liable As Control Persons Under § 20(a)

To plead a control person claim under § 20(a), the Complaint must allege (i) a primary violation of the federal securities laws, and (ii) that the defendant exercised "control" over the primary violator. *MicroStrategy*, 115 F. Supp. 2d at 661. Here, the Individual Defendants do not dispute that they are "control persons" of the Company, contending only that Plaintiffs fail to allege a primary violation. Def. Br. at 35 n.31. Because the Complaint alleges primary violations of § 10(b), it likewise states a claim for control person liability under § 20(a). *See Genworth*, U.S. Dist. LEXIS 57600, at *75 ("On a motion to dismiss, a § 20(a) claim will thus stand or fall based on the court's decision regarding the § 10(b) claim.").

Strangely, Defendants assail a § 10(b) claim against Schlegel that the Complaint does not assert. *See* Def. Br. at 21 n.19. Defendants' motion does not dispute that the Complaint alleges a § 20(a) claim against Schlegel.[49]

IV. CONCLUSION

Defendants' motion to dismiss should be denied. If the Court grants any part of Defendants' motion, Plaintiffs respectfully request leave to amend pursuant to Fed. R. Civ. P. 15.[50]

Dated: July 14, 2015

Respectfully submitted,

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[49] As the Company's Chief Merchandising Officer, Schlegel ran the Company's sourcing initiatives, travelled with Lynch to China, personally witnessed the illegal operations of the suppliers in China and was present during conference calls when misrepresentations and omissions were made. *See* ¶¶38, 48, 54-56, 59, 62-63, 66-67, 103, 105, 110. Thus, he "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws ... [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability." *MicroStrategy*, 115 F. Supp. 2d at 66; *Masterson v. Commonwealth Bankshares, Inc.*, 2 F. Supp. 3d 824, 830 (E.D. Va. 2014) ("Plaintiffs need not allege 'culpable participation' … as part of their prima facie case [for § 20(a)].").

[50] Leave to amend is liberally granted and should only be denied "when the amendment would be prejudicial to the opposing party, there has been bad faith on the part of the moving party, or the amendment would be futile." *Nolte v. Capital One Fin. Corp.*, 390 F.3d, 311 317 (4th Cir. 2004).

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CERTIFICATE OF SERVICE

I, Elizabeth A. Aniskevich, hereby certify that on July 14, 2015, I caused a copy of the foregoing to be served on all parties via the Court's ECF filing system.

/s/ *Elizabeth A. Aniskevich*
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